HOW MULTIFAMILY RENTAL PROPERTIES ARE FINANCED

AOBA
APARTMENT AND OFFICE BUILDING ASSOCIATION OF METROPOLITAN WASHINGTON

Rental housing serves an essential role in the viability of a community. It represents the most affordable type of housing and is critical to accommodating the workforce that fuels our local economy. Yet our region suffers from an extreme undersupply of housing. According to the Metropolitan Washington Council of Governments, we need to add 320,000 new units of housing by 2030 just to keep pace with demand.

To understand how we can create a hospitable environment to attract new housing production to our community, it is important to understand who investors are and how multifamily projects are financed.

01 Our region competes nationally and even globally to attract investors to build new housing stock.

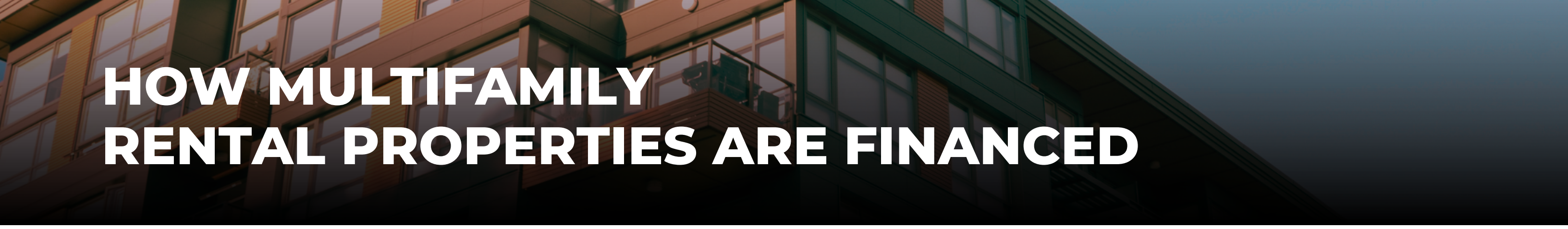
02 Banks and lending institutions play a critical role in providing financing to seed new rental housing development.

03 The vast majority of rental income goes to cover the operating costs of a community.

04 Investors rely on refinancing to draw equity from their property and reinvest in the community.

05 Equity drawn from a property in refinancing is used to fund major capital expenses associated with a property and to improve the quality of housing. It can also be leveraged to create a chain of investments and build new housing stock.

06 If an investor is unable to secure refinancing, it may result in an outright loss of affordable housing stock.



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01 **Who are investors?** ***There are several common models of rental housing ownership.*** These range from small Independent rental owners (IROs), who may own and manage a relatively small number of units that they use to supplement their income or as a source of retirement income, all the way up to large real estate investment trusts (REITS) and institutional investors like insurance companies, college endowments, and state and local employee pension funds. Even large corporate owners maintain a vested interest in the communities they serve as they typically rely on local property management companies to oversee the day-to-day operations and upkeep of a property.

02 **How are multifamily projects financed?** ***The upfront costs of building a multifamily property are very high, driven by land prices and the cost of financing and construction.*** Thus financing is needed to build a development. Multifamily development loans generally require 25 to 35% of the project's total cost to be invested as cash equity. The rest of the cost of development is financed by traditional banks, credit unions, commercial lenders, and even private investors. In certain cases, multifamily loans are available through federal institutions such as Fannie Mae and Freddie Mac. ***Dedicated affordable housing financing usually requires additional funding or subsidies to bridge the gap between projected revenues and the cost of building and operating the property and to qualify for a loan.***

03 **Where does rent go?** ***After operating and financing costs, only a small portion of income goes back to owners and investors.*** **This modest sum may be paid out in the form of quarterly or annual dividends.** This assumes a strong rental market with full occupancy and rent collection. Lesser revenues and even losses may be common during downturns. ***The bulk of rental income goes to fund the operations of the property,*** including mortgage payments and interest, payroll, utilities, business licenses and other taxes, hazard and liability insurance, in-apartment routine repair and maintenance, contract services like waste collection, janitorial services, maintenance of mechanical systems, boilers, air conditioning systems and elevators, and fire suppression systems. ***Some may additionally be set aside for very costly replacement reserves for major system replacement and repairs*** to windows, masonry, roofs, elevators, plumbing, electrical and HVAC.

04 **So where do profits come from?** Rising rents rarely produce profit, because rents rise as a trailing indicator of rising costs. Rather, as detailed above, rents overwhelmingly go toward paying operating expenses and reinvesting in the asset. ***Investors gain primarily from value growth of their assets. To this end, multifamily investors make use of a loan management strategy wherein the borrower relies on refinancing*** to take advantage of built-up equity in the property. Multifamily loans are typically amortized over 20 to 30 years. But unlike a single-family mortgage, banks require the entire loan to be repaid in full after a much short term – typically 3, 5, 7 or 10 years. The interest and principal payments on a longer-term note would render an investment unprofitable and not financeable in most cases. ***This results in the necessity of refinancing (or selling) to avoid this giant "balloon payment" at the end of the term. This takes the form of a new mortgage, which restarts this same cycle over again.***

05 **Where do the "profits" go?** The prospect of investment growth is much of what attracts investors to invest in rental housing for our community. Since the best way to find value growth is to continue to reinvest in communities, investors seek to improve the quality of the housing provided during each cycle. ***Upon purchase or refinancing, an investor often needs to fund large-scale renovations, improvements, and capital expenses.*** Additional capital expenses, and operating cost increases must be met via normal regular increases in rent, or a reduction in services to residents, or a deferral of planned capital investments.

06 **What happens if the investor or property can't refinance?** Multifamily financing ultimately relies on a property increasing in value over time and capitalizing on favorable interest rates and cap rates at the time of refinance or purchase. But like any investment, there is economic risk. ***Many investors are likely to find themselves in a precarious position in our current environment in which interest rates have skyrocketed, revenues (rent collection) are stagnant or even declining, and regulation and flight from cities has diverted investor attention away from real estate. Banks qualify buildings for financing based on a handful of metrics tied to the property's income stream.*** The property's net operating income or "NOI" (income left over after paying all of the property's operating expenses) is used to determine the property's value. Financial pressures, cost inflation and perceived risk in investing in multifamily real estate (attributable to income restrictions and regulatory environments) have driven values down. ***Lower values mean decreased availability of financing. As a general rule of thumb, lenders look for a debt service coverage ratio (DSCR) of around 1.25X after paying all expenses of the property, plus any required set-asides for capital improvements and maintenance.*** This means that NOI must equal or exceed 1.25 times the amount of debt service (principal and interest payments). As interest rates rise, it takes more money left over after all expenses are paid to qualify for the same amount of debt. If income is falling too that creates a double pinch. As the market gets more challenging due to interest rates and competition for investment dollars with other asset classes, investors are less willing to invest, and lenders are less willing to lend. ***This translates to lower loan-to-value ratios.*** That means the investor or building owner has to put more equity in to purchase or refinance the building. If an owner who is at maturity on their current debt cannot get a loan that at least pays off the current debt, then they either have to come out of pocket to fill the gap, sell, or face the risk of foreclosure.